

Economic Outlook

By any measure, 1999 was a remarkable year for the U.S. and California economies.

Nationally, real economic growth averaged almost 4 percent—a very strong pace for an expansion that in February will become the longest upturn in U.S. history. Despite robust growth and low unemployment, which reached a 30-year low of 4.1 percent in November 1999, inflation has remained subdued. Consumer prices averaged a 2.2 percent increase last year, while the more comprehensive gross domestic product (GDP) price index rose a scant 1.2 percent.

There is little doubt that California is now a full participant (more accurately a leading force) in the nation's remarkable economic growth. The state's unemployment rate, at 4.8 percent in November, is the lowest ever recorded on the current basis, which dates from January 1970. The gap between the U.S. and California jobless rates, which reached a peak of almost 3 percentage points in 1994, is currently down to 0.7 percent. California's nonfarm job growth of 3.3 percent last year was half-again the nation's 2.2 percent increase.

The Nation: A Clearer Picture—U.S. prospects for 2000 and 2001 have improved markedly in recent months. In late October, the U.S. Bureau of Economic Analysis (BEA) issued a major or "comprehensive" revision of gross domestic product, incorporating several important conceptual changes as well as routine data updates. The revised GDP figures reveal an economy growing at a faster pace than previously estimated. Most significantly, the additional growth is powered by productivity gains that are sharply higher than originally calculated. Indeed, in the new figures, growth in output per hour of work is now approaching levels not seen since the "golden age" of U.S. productivity during the quarter century following World War II.

It is particularly encouraging that productivity has actually improved as the business cycle has aged. In virtually all recoveries, the rapid assimilation of underutilized plant and unemployed workers has provided a short-term boost to productivity in the early stages of a business upswing. But as factors of production become more fully employed, productivity gains become more difficult to achieve. Economies of scale are reached and incremental labor is often less experienced and less skilled as the jobless rate falls. However, as [Figure ECON-1](#) shows, in the current upswing, productivity gains in the late 1990s are actually higher than in the earlier stages of the recovery and expansion.

The difference in this cycle is the payoff from large, ongoing investments in information technology, which are boosting productivity in a wide variety of industries, especially in the service-producing segments of the economy. A striking example is in retail trade, where job growth of little more than 1 percent has lagged far behind the 6 to 7 percent growth in real sales volume, implying very large gains in sales per worker. The revised data provide a better and more positive picture of output and productivity in the financial sector. Financial institutions have made huge investments in technology, and the new measurements clearly show the payoff in rising output per worker.

The gains in productivity are also a major element in keeping inflation low. Over the past year, for example, unit labor costs (the rise in wages offset by the increase in output per hour) rose by a scant 0.9 percent in the nonfinancial corporate sector, as a 3.8 percent rise in productivity absorbed most of the 4.8 percent increase in workers' hourly compensation.

Even considering the very slow 1 percent annual increase in the working-age population, the higher productivity figures imply potential economic growth of 3.5 percent per year or more—well above the 2.2 to 2.5 percent "speed limit" set by Federal Reserve policy makers less than two years ago. Worries over a tight labor market may persist, but the new figures suggest that a major slowdown in economic growth is unlikely.

Indeed, the main reason to expect a modest slowing of economic growth is the prospect of slower job gains, ultimately limited by the slow growth of the working-age population. The unemployment rate may yet fall a few more ticks, but it is hard to imagine that job gains can continue at twice the pace of labor force growth for too much longer.

Following are key elements of the 2000-01 U.S. economic forecast ([also see Figure ECON-6](#)):

- Real GDP is expected to grow 3.1 percent this year and 2.8 percent in 2001. While still quite robust by past standards, the forecast represents a modest slowing from three consecutive years of 3.9 percent economic growth.
- Inflation inched up slightly in 1999, and is expected to rise a bit more in 2000. Rising industrial commodity prices and somewhat higher compensation costs are expected to boost consumer prices by 2.9 percent this year and 2.5 percent in 2001. The broader GDP price index is expected to remain below 2 percent, rising 1.7 percent in 2000 and 1.6 percent in 2001.
- The combination of low unemployment and the gradual up-tick in inflation will probably prompt the Federal Reserve to boost short-term interest rates by perhaps 0.5 percent in 2000, from late-1999 levels. Longer-term rates, which often move in anticipation of Fed action, will probably rise little more than 0.25 percent from recent levels.

California: The Engine of Growth—It is difficult to overstate the contribution that California is making to the nation's improved economic prospects. The state has by far the largest concentration of high-technology industries and jobs anywhere in the world.

While high-tech manufacturing has suffered until recently from weak overseas demand, gains in computer services (mainly software and the Internet) are more than taking up the slack. In the year ending June 1999 (the latest data available) the computer services segment of business services grew at an annual pace of 16.1 percent. The 39,000 new jobs added during that period were more than double the job losses in the seven high-technology manufacturing industries combined (computers, electronics components, communications equipment, measuring instruments, aircraft, missiles and space, and navigation instruments). With mid-1999 employment of 281,400—almost certainly well over 300,000 by the beginning of this year—computer services is by far the largest single high-technology sector, nearly double the 157,000 workers in the electronics components industry.

Moreover, prospects for much of the high-technology manufacturing sector are also beginning to brighten—the result of a marked improvement in the outlook for major foreign economies. Recovery in most of Asia is now well established, and even in Japan it appears that the worst is over. Meanwhile, Mexico has recently surpassed Japan as California's leading overall export market, as the state's southern neighbor successfully weathered the effects of the 1998-99 South American currency crisis.

After stumbling in early 1999, major European economies are experiencing faster economic growth. The impact of stronger overseas growth is clearly visible in the sharp turnaround in California-made exports during the third quarter of 1999. Total California exports grew more than 10 percent over the year-earlier period (the first gain since 1997) while shipments to East Asia (excluding Japan) jumped almost 50 percent ([Figure ECON-2](#)).

Among other major export industries, motion pictures will also benefit from stronger overseas economies. Growth in motion picture production slowed in 1998 and early 1999, mainly reflecting cutbacks by major studios following overproduction and poor profitability in 1997 and 1998. In 1999, box office receipts were up over 9 percent, despite a reduction in the number of films in general release. With profits returning to the industry, there is renewed interest in undertaking major projects this year and in 2001. Although growth has slowed from the very high levels in the early 1990s, production jobs are still posting solid annual gains in the 4 to 5 percent range.

Key elements in the California forecast are as follows (and in [Figure ECON-6](#)):

- California nonfarm employment is forecast to increase 2.9 percent this year—more than 400,000 new jobs, down slightly from 1999's 3.3 percent advance. In 2001, the state is expected to create 367,000 new jobs, a 2.5 percent increase over this year's expected level.
- California personal income will top the \$1 trillion mark for the first time in 2000. This year, personal income is expected to maintain the recent vigorous pace, rising 6.5 percent, little changed from 1999's estimated 6.6 percent increase. In 2001, income gains are expected to slow to 5.7 percent.
- Following four years of strong growth, California nonresidential construction is expected to post gains of 10.8 percent in 2000, followed by an 11.5 percent advance in 2001.
- Homebuilding remains the single cloud on California's otherwise bright economic horizon. Despite record sales of existing homes, accompanied by sharply higher prices, new home construction appears to have fallen short of 140,000 units last year. Continued modest growth to 154,000 new units this year and 167,000 in 2001 will depend crucially on the ability of builders to obtain lot and subdivision approvals from local planning agencies. Apart from housing's direct contribution to jobs and incomes, the low level of new construction activity may now be a constraining factor on economic growth in many of California's densely populated coastal counties.
- California's escalating housing costs are translating into a higher inflation rate. In 1999, the California consumer price index (a weighted average of the Bay Area and Los Angeles region CPIs) increased 3.0 percent, compared to the nation's 2.2 percent advance. The Los Angeles region index increased 2.4 percent, but in the Bay Area, prices jumped 4.3 percent, led by a 7.0 percent increase in rents and a 6.7 percent rise in homeowners' costs. Both figures are more than double the nationwide rise in housing costs of 2.9 percent. This year, the California inflation measure is expected to increase 3.5 percent, followed by a 3.3 percent rise in 2001.

[Figure ECON-3](#)

Risks to the Forecast—As the current economic expansion moves into record territory next month, the question inevitably will be asked, "How much longer can it continue?" Fortunately, business cycle expansions rarely "die of old age." Virtually every downturn has been triggered by an external shock, an economic policy error, or the emergence of imbalances and excesses in the economy.

By their very nature, external shocks are nearly impossible to predict. It is noteworthy, however, that a near tripling in oil prices from late 1998 to late 1999 has to date had no visible effect on the strength of the current upswing.

A major policy error would require that the Federal Reserve discard its current cautious and well-reasoned approach to monetary policy. As noted, the Fed has been quite willing to accept the higher economic growth rates implied in the new GDP figures. It continues to express concern over the possible effects of tight labor markets on employee compensation, but the rate of wage increases actually moderated somewhat in the second half of last year, even as the jobless rate fell to a 30-year low.

Interest rates are notoriously difficult to predict, but a large policy-induced leap of 2 percent or more, for example, does not seem justified by current or prospective economic conditions.

In the past, excess business inventories, nonresidential overbuilding, high household debt burdens or sharp increases in prices and interest rates have been significant contributors to economic downturns. None of these is present in today's economy. In fact, the overall ratio of business inventories to sales is at a record low. The excesses of the 1980s boom in new office construction have been avoided. The household debt service ratio (the proportion of incomes needed to make contractual monthly payments) is high, but still comfortably below the 1989 peak. Inflation has actually declined through much of this long expansion, and the small gain expected this year mainly reflects a rise in worldwide industrial commodity prices (led by oil) and a modest up tick in wages. At the same time, abundant crops are leading to significant declines in most farm commodity prices.

The stock market is the one important segment of the economy that raises legitimate grounds for concern. The most basic valuation of the market, the price to earnings ratio (P/E), hit record levels in 1999. In the first half of last year, prices of shares in the Standard and Poor's 500 stock index reached nearly 35 times the previous year's earnings—by far the highest since records began in 1926.

Moreover, the P/E ratio has been at unprecedented levels since 1997 ([Figure ECON-4](#)), a fact that has made most economic forecasters (including those at the Department of Finance) very reluctant over the last several years to project further outsized gains in stock prices. Because the market affects both consumer spending (by making share-owning households wealthier) and business investment (by lowering the cost of capital), the continued surge in stock prices is the principal source of most recent forecasting errors. As discussed in the following section on revenues, a large and increasing share of California General Fund revenue is directly related to the market, in the form of both capital gains and employee stock options.

Several explanations have been offered for the persistently high stock market valuation, many of them on rather arcane statistical grounds that do not stand up to close scrutiny. Perhaps the most plausible explanation is that the market is in the midst of a systemic re-evaluation of future investment returns, reflecting significantly enhanced prospects for U.S. economic growth based on the apparent upswing in productivity. The problem is that it is difficult to gauge first, whether higher productivity represents a lasting trend or a one-time increase, and second, how much of the new productivity trend has by now been incorporated into stock prices.

Given this uncertainty, the forecast assumes modest increases in stock prices over the 2000-01 horizon, below the double-digit gains of the last five years. The stock market could very well continue to soar by 10 or 20 percent a year, in which case both economic and revenue forecasts will have again been underestimated. But from these lofty levels, a decline in the market clearly cannot be ruled out.

Moreover, a growing number of market analysts are becoming increasingly uncomfortable with the massive market valuations placed on "dot.com" and other software stocks, many of them recent initial public offerings with few prospects of turning a profit in the foreseeable future. The ability of these companies to attract capital has no doubt been an important element in

California's recent economic growth, but the state's exposure to this highly speculative segment of the market is also significantly greater than in most other parts of the nation.

Technical Note on the U.S. Forecast

On October 28, 1999, the U.S. Bureau of Economic Analysis (BEA) released a "comprehensive revision" to the national income and product accounts. In addition to annual and tri-annual data revisions, the new figures incorporate several important conceptual changes, including the addition of software to business fixed investment and improved measures of output in the financial services sector. Personal income revisions were also significant, conforming the treatment of public sector pensions to similar private pension plans.

Given the scope of the revisions, detailed historical data are being released over a three-month period, delaying the necessary re-estimation of the U.S. model used by the Department of Finance. Moreover, state personal income figures will not be revised to reflect the new definitions until May 17, 2000, thus temporarily breaking an important link between the U.S. and California forecasts.

In these circumstances, this forecast is based on the pre-revision data set, but takes account of the new, higher productivity trend revealed in the new data. As a check, the Department ran the U.S. forecast on a version of the national model that essentially translates the old data into the new framework and base year. (Inflation measures were updated to a base of 1996 = 100 from the previous 1992 reference point.) As shown in [Figure ECON-5](#), the new and old basis forecasts are virtually identical.